APPENDIX A

THE SUPREME COURT OF OHIO
1995 TERM

To wit: March 1, 1995

Case No. 94-2439

SERENE G. SHAPER,
Appellant/Cross-Appellee,

v.

ROGER W. TRACY, Tax Commission Director of
Ohio Department of Revenue,
Appellee/Cross-Appellant.

ENTRY

Upon consideration of the jurisdictional memoranda filed in this case, the Court declines jurisdiction to hear the case and dismisses the appeal and the cross-appeal as not involving any substantial constitutional question.

COSTS:

Docket Fee, $40.00, paid by Benesch, Friedlander, Coplan & Aronoff.

COSTS:

Docket Fee, $40.00, paid by James Lawrence.

(Franklin County Court of Appeals; No. 94APE0132)

/s/ Thomas J. Moyer
THOMAS J. MOYER
Chief Justice

APPENDIX B

IN THE COURT OF APPEALS OF OHIO
TENTH APPELLATE DISTRICT

No. 94APE01-32

(Regular Calendar)

SERENE G. SHAPER,
Plaintiff-Appellant,

v.

ROGER W. TRACY, Tax Commission Director of Ohio Department of Revenue,
Defendant-Appellee.

OPINION

Rendered on September 29, 1994

APPEAL from the Franklin County Court of Common Pleas.

YOUNG, J.

This matter is before this court upon the appeal of Serene G. Shaper, appellant, from the December 7, 1993 judgment entry of the Franklin County Court of Common Pleas granting summary judgment in favor of Roger W. Tracy, Tax Commissioner of Ohio and Lee Fisher, Attorney General of Ohio, appellees. The history of this case is as follows: appellant is an Ohio resident who owns municipal bonds issued by non-Ohio entities. Appellant filed this action seeking declaratory and injunctive relief, pursuant to R.C. 2721.02 and Section 1983, Title 42, U.S.Code. Appellant claims that R.C. 5747.01(A)(1)

is discriminatory because it includes in adjusted gross income the "interest or dividends on obligations or securities of any state or of any political subdivision or authority of any state," while exempting interest earned on bonds issued by Ohio and its subdivisions and authorities. Appellant sought to enjoin the appellee from assessing and collecting state income tax on interest earned by Ohio residents who owned bonds issued by governmental entities outside of the state of Ohio, and argued that Ohio's taxation scheme violated the Commerce Clause of the United States Constitution.[1] Appellant also moved for class certification and for summary judgment. Appellees moved for summary judgment, and argued that appellant could not maintain an action for declaratory and injunctive relief under Ohio law, because she was limited to the administrative refund claim procedure and was required to exhaust those remedies first. Appellees also argued that appellant was not entitled to relief pursuant to Section 1983, Title 42, U.S.Code and that R.C. 5747.01(A)(1) did not violate the Commerce Clause.

The trial court found that Ohio law permits a party to challenge the constitutionality of a state tax provision via a declaratory judgment action, and that appellant was not required to first exhaust her administrative remedies. However, the trial court found that appellant was not entitled to maintain an action pursuant to Section 1983, Tile 42, U.S.Code, when she had full and adequate state remedies. In addition, the trial court found that appellant was not entitled to injunctive relief unless and until the court determined that R.C. 5747.01(A)(1) was unconstitutional. The trial court held that R.C. 5747.01(A)(1) was not violative of the Commerce

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[1] The Commerce Clause provides: "[t]he Congress shall have Power * * * [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes[.]" Article I, Section (8), Clause 3 of the United States Constitution.

Clause for two reasons. Initially, the court noted that if the Commerce Clause were to apply, the market participant doctrine exempted Ohio's activity from Commerce Clause scrutiny. Secondly, the court explained that the Commerce Clause had not been applied to acts of a sovereign on behalf of itself, (as opposed to its citizenry), which provided the sovereign with a competitive advantage over another sovereign. Accordingly, the trial court granted summary judgment in favor of appellees, and denied appellant's motion for summary judgment.

Appellant filed this appeal and asserts the following assignments of error:

> "The trial court erred in granting the state defendants' motions for summary judgment (Assignment of Error No. 1) and in denying plaintiff's motion for summary judgment (Assignment of Error No. 2)."

Appellant also presents the following issues for review:

> "1. Whether, in a declaratory action against state officials challenging a state tax provision asserted to violate the Commerce Clause on its face, the action may be maintained, as one of its counts, under 42 U.S.C. § 1983 (Assignments of Error Nos. 1 and 2).
>
> "2. Whether a state violates the Commerce Clause by its discriminatory income taxation of municipal bond interest on only the interest from bonds issued by non-Ohio issuers, while exempting interest earned on all bonds issued by Ohio entities (Assignments of Error Nos. 1 and 2).
>
> "3. Does the Commerce Clause of the United States Constitution prohibit states from discriminating in their own interests, by an income tax that explicitly taxes only the interest earned from other states' bonds?
>
> "4. Does he Commerce Clause not apply to state actions for their own fiscal benefit, in taxation

schemes which intentionally discriminate against out-of-state bond issues?"

The instant action is before this court on an appeal from summary judgment. Summary judgment is proper when reasonable minds can come to but one conclusion, and that conclusion is adverse to the party against whom the motion for summary judgment is made, such party being entitled to have the evidence or stipulation construed most strongly in its favor. Civ.R. 56(C). The parties agree that this case involves a question of law, rather than issues material fact.

Appellant challenges the constitutionality of R.C. 5747.01(A)(1) which taxes the interest on obligations issued by non-Ohio governmental entities, while exempting any interest earned on obligations issued by Ohio governmental entities. R.C. 5747.01(A) provides in pertinent part:

> "'Adjusted gross income' means adjusted gross income as defined and used in the Internal Revenue Code, adjusted as follows:
>
> "(1) Add interest or dividends on obligations or securities of any state or of any political subdivision or authority of any state, other than this state and its subdivision and authorities[.]"

The trial court found that R.C. 5747.01(A)(1) was constitutional and did not violate the Commerce Clause for two reasons. Initially, the court found that the state of Ohio acts as a market participant when it issues bonds. The market participant doctrine recognizes that when a sovereign acts as a consumer or vendor in commerce, its actions as a market participant are distinct from its actions as a market regulator. The Commerce Clause is directed at the state's actions as a market regulator, therefore, actions as a market participant are exempt from Commerce Clause analysis. Clearly, when a state chooses to sell bonds and enter into the securities market,

it is acting as a market participant. However, when a state chooses to tax its citizens, it is acting as a market regulator. As stated by the United States Supreme Court:

> "The market-participant doctrine has no application here. The Ohio action ultimately at issue is neither its purchase nor its sale of ethanol, but its assessment and computation of taxes—a primeval governmental activity. To be sure, the tax credit scheme has the purpose and effect of subsidizing a particular industry, as do many dispositions of the tax laws. That does not transform it into a form of state participation in the free market. * * *" *New Energy Company of Indiana v. Limbach* (1988), 108 S.Ct. 1803, 1809.

Thus, we find that the market participation doctrine has no application to the instant action, as the state of Ohio is acting as a market regulator in its assessments of taxes.

However, we do agree with the trial court's conclusion that neither the Supreme Court, nor any case law examined, has applied the Commerce Clause to a case such as this, where one governmental entity is taxing its residents for the interest earned on bonds issued by another governmental entity. The trial court found that much of the Commerce Clause case law developed thus far, involved taxation schemes that benefitted a private industry or business in the state, to the detriment of out-of-state businesses. Accordingly, the trial court found that the Commerce Clause was simply never intended to apply to acts of a sovereign on behalf *of itself* where the end result is to provide the taxing state with a competitive advantage over *another* sovereign. Because the court found that the Commerce Clause did not apply to such a scenario, it found that R.C. 5747.01(A)(1) was not unconstitutional.

A review of the case law developed by the United States Supreme Court demonstrates that the Commerce

Clause has been directed at acts of a sovereign on behalf of its citizenry to improperly provide *its citizenry* with a competitive advantage over the *citizenry* of other states. The parties herein, have provided this court with numerous Commerce Clause cases, whereby taxation schemes were challenged when a state's taxation scheme dicriminates against out-of-state businesses or entities. See *Dominion National Bank v. Olsen* (6th Cir. 1985), 771 F.2d 108; *Boston Stock Exchange v. State Tax Commission* (1977), 429 U.S. 318, 97 S.Ct. 599; *Madden v. Commonwealth of Kentucky* (1940), 309 U.S. 83, 60 S.Ct. 406. None of the cases cited are directly on point. The instant action does not involve a taxation scheme whereby the citizenry of Ohio are provided with a competitive advantage over the citizenry of other states. Rather, the taxation scheme in the instant action benefits the state of Ohio itself.

Appellant is challenging Ohio's taxation scheme because Ohio includes, as adjusted gross income, interest income appellant earns from the bonds of other states. This court, after extensive research, has only been able to locate one case that is factually close, although the tax in question was not challenged on Commerce Clause grounds. In *Bonaparte v. Tax Court* (1881), 104 U.S. 592, the Supreme Court stated that "[t]he Constitution does not prohibit a State from including in the taxable property of her citizens so much of the registered public debt of another State as they respectively hold, although the debtor State may exempt it from taxation or actually tax it." *Id.* at syllabus. In *Bonaparte,* the taxpayer argued that, because the debtor state exempted its bonds from taxation, the taxpayer's resident state was required to exempt the bonds pursuant to the full faith and credit clause. The Supreme Court rejected this argument and stated: "[i]t is true, if a State could protect its securities from taxation everywhere, it might succeed in borrowing money * * * but, * * * it cannot secure such exemption outside of its own jurisdiction * * *." *Id.* at 595. In

writing for the majority, Chief Justice Waite stated: "[w]e know of no provision of the Constitution of the United States which prohibits such taxation." *Id.* at 594.

In other cases cited by the parties, the relationship between a state and the federal government was crucial to the court's analysis. *Davis v. Michigan Dept. of Treasury* (1989), 489 U.S. 803, 109 S.Ct. 1500; *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 103 S.Ct. 692. These cases balance a state's interest against the *federal* government's interest. Thus, questions concerning states' rights and the Tenth Amendment are often implicated. As a result, these cases are not directly on point, as the case before us involves the relationship between Ohio and other *states.* However, we find the case of *South Carolina v. Baker* (1988), 45 U.S. 505, somewhat helpful to our analysis. In that case, the Supreme Court held that state bond interest was not immune from nondiscriminatory federal tax. (Overruling *Pollock v. Farmers' Loan & Trust Co.* (1895), 157 U.S. 429, 15 S.Ct. 673.) The court stated as follows:

> "* * * *The owners of state bonds have no constitutional entitlement not to pay taxes on income they earn from the bonds* and States have no constitutional entitlement to issue bonds paying lower interest rates than other issuers. * * *" *Id.* at paragraph two of the syllabus. (Emphasis added.)

It must be noted that the tax on the state bond interest in *South Carolina v. Baker* was not challenged on Commerce Clause grounds.

We agree with the trial court's rationale that "neither the Supreme Court nor any case law examined has applied the Commerce Clause to actions between government entities. Each state has a legitimate interest in tapping a major source of tax revenue while adding an incentive for investors to purchase state bonds. Those purchasers then become the major beneficiaries of the

issuance of the bonds for state issues, capital improvements, and similar benefits." Given the lack of any precedent to apply the Commerce Clause to this type of taxation scheme, we are unable to find R.C. 5747.01 unconstitutional as violative of the Commerce Clause.

The next issue we must address is whether or not the trial court erred in finding that appellant does not have the right to maintain a Section 1983, Title 42, U.S.Code action in Ohio courts to challenge an alleged unconstitutional tax provision. The trial court found that appellant could not maintain a Section 1983, Title 42, U.S. Code challenge to the statute, because state remedies offer her full and adequate relief. On appeal, appellant argues that her state remedies do not provide full and adequate relief.

Initially we note that Commerce Clause violations are cognizable under Section 1983, Title 42, U.S.Code. *Dennis v. Higgins* (1991), 111 S.Ct. 865. The type of relief sought, however, is critical to our analysis. To the extent that appellant seeks monetary damages, her Section 1983, Title 42, U.S.Code claim must fail. When sued for damages, state and state officials acting in their official capicities are not "persons" pursuant to Section 1983, Title 42, U.S.Code. *Will v. Michigan Department of State Police* (1989), 491 U.S. 58, 109 S.Ct. 2304. In a case where a party seeks injunctive, or prospective relief, a state official in his or her official capacity does qualify as a "person" for purposes of Section 1983, Title 42, U.S.Code. *Id.* at 71, 2312.

In a similar case, the Indiana Supreme Court held that the taxpayer had no cognizable claim under Section 1983, Title 42, U.S.Code for damages against the Department of State Revenue. In that case, the taxpayer alleged that an intangibles tax violated the Commerce Clause. The court held that there was no cognizable claim, because the state was acting in its official capacity in enacting and collecting the tax. *Indiana Dept. of State Revenue v.*

Felix (Ind. 1991), 571 N.E.2d 287. The court further held that the taxpayer had no cognizable suit under Section 1983, Title 42, U.S.Code for declaratory or injunctive relief, as the tax did not violate the Commerce Clause. *Id.* at 295. As stated by the Supreme Court of Indiana: "* * * [e]ven if the tax had not been repealed, our determination that the tax is constitutional would have resolved any claim for such relief. Plaintiffs have no cognizable suit for relief under § 1983." *Id.* at 295.

We find the above rationale pertinent to the instant action. Because we have no precedent to apply the Commerce Clause, and hav upheld the taxation statute in question, any claim that appellant may have pursuant to Section 1983, Ttile 42, U.S.Code is moot.

We would also note that appellant has asked for a class action in this case, and that the trial court did not rule upon this request. As stated in *Aronson v. Commonwealth* (Mass. 1987), 516 N.E.2d 137:

> "* * * It is one thing to tolerate, outside normal administrative procedures, an action for declaratory relief * * * [w]here, however, an attempt is made to obtain refunds of substantial amounts of money on behalf of numerous unidentified taxpayers, the procedures of the administrative process should not be bypassed. Tax collectors and other public officials are entitled to know what portion of collected revenues is subject to challenge and are entitled to insist on adherence to fixed schedules for timely applications for abatement and for other steps in the administrative process. We find unacceptable such an open-ended contingent liability based on an action for declaratory relief. A class should not be certified in actions of this character." *Id.* at 144.

We find the reasoning in *Aronson* persuasive. However, we also find that the issue of class certification is moot, because appellant is not entitled to relief. As

stated by the court in *Indiana Department of State Revenue v. Felix, supra*: "[i]nasmuch as the Clerks have lost their case on the merits, their contention of error concerning their role as representatives of class members similarly situated is moot." *Id.* at 296.

Accordingly, appellant's assignment of error, and issues for review, are overruled and the Franklin County Court of Common Pleas entering summary judgment in favor of appellees is hereby arffimed.

Judgment affirmed.

BRYANT and MAHONEY, JJ., concur.

MAHONEY, J., retired, of the Ninth Appellate District, assigned to active duty under the authority of Section 6(C), Article IV, Ohio Constitution.

BRYANT, J., concurring.

Concurring in the majority's analysis of appellant's contentions under the Commerce Clause, and the majority's determination that its conclusion under the Commerce Clause renders her arguments under Section 1983, Title 42, U.S.Code moot, I thus concur in the majority's holding that the judgment of the trial court is affirmed.

APPENDIX C

[Filed Sep. 29, 1994]

IN THE COURT OF APPEALS OF OHIO
TENTH APPELLANT DISTRICT

No. 94APE01-32

(Regular Calendar)

SERENE G. SHAPER,
Plaintiff-Appellant,

v.

ROGER W. TRACY, Tax Commission Director of
Ohio Department of Revenue,
Defendant-Appellee.

JOURNAL ENTRY OF JUDGMENT

For the reasons stated in the opinion of this court rendered herein on September 29, 1994, the assignment of error is overruled, and it is the judgment and order of this court that the judgment of the Franklin County Court of Common Pleas is affirmed.

YOUNG, BRYANT & MAHONEY, JJ.

By /s/ John C. Young
JUDGE JOHN C. YOUNG

MAHONEY, J., retired, of the Ninth Appellate District, asigned to active duty under the authority of Section 6(C), Article IV, Ohio Constitution.

APPENDIX D

[Filed Nov. 12, 1993]

COURT OF COMMON PLEAS
FRANKLIN COUNTY, OHIO

Case No. 93CVH-11-9271

Judge Evelyn J. Stratton

SERENE G. SHAPER,

Plaintiff,

v.

ROGER W. TRACY, TAX COMMISSIONER OF OHIO,

Defendant.

DECISION

Rendered this ——— day of November, 1993.

STRATTON, E.

This matter is before the Court on Cross-Motions for Summary Judgment filed by all parties. All parties agree that there are no issues of fact and that the decision of this Court rests purely on the law. The Court has reviewed all the numerous responses and replies, including Plaintiff's Post-Argument Brief and Defendant's Reply.

The issues are relatively straight-forward:

I. May the Plaintiff maintain an action for declaratory and injunctive relief?

II. Is Plaintiff required to exhaust her administrative remedies first?

III. Does Plaintiff have the right to a 42 U.S.C. § 1983 action?

IV. Does O.R.C. § 5747.01(A)(1) which taxes the interest income on obligations of non-Ohio obligations, while exempting such taxation of Ohio obligations, violative of the Commerce Clause of the United States Constitution?

I. MAY THE PLAINTIFF MAINTAIN AN ACTION FOR DECLARATORY AND INJUNCTIVE RELIEF?

The Court finds that Plaintiff may maintain an action for declaratory relief. This issue has now been clearly resolved by the Ohio Supreme Court in *State ex rel. Tracy F. Franklin County Common Pleas Ct.*, No. 93-459, in which the Supreme Court declared that O.R.C. 2723.01 gives Common Pleas Courts such authority:

> § 2723.01 Jurisdiction of courts of common pleas.
>
> Courts of common pleas may enjoin the illegal levy or collection of taxes and assessments and entertain actions to recover them when collected, without regard to the amount thereof, but no recovery shall be had unless the action is brought within one year after the taxes or assessments are collected.

However, the Supreme Court also found that the Common Pleas Court must first make a determination of illegality before granting any such injunction. Therefore, this Court must first reach the legal issues in the declaratory judgment action before addressing remedies.

II. IS PLAINTIFF REQUIRED TO EXHAUST HER ADMINISTRATIVE REMEDIES FIRST?

The Court finds that Plaintiff is not required to first exhaust her administrative remedies before seeking declaratory relief.

Plaintiff has filed for a refund with the Board of Tax Commissioners which has now reached a Final Determination in the Personal Income Tax Refund Claim No.

IT-6832 for tax years 1988-1991 filed by Serene G. Shaper. That Final Determination correctly states the Commissioner has no authority to deal with class actions. The Final Determination appears to go on to consider some of the constitutional claims, although the Tax Commissioner has no authority to declare such taxes illegal or unconstitutional. The Tax Commissiontr rejected the refund claim and that case may now proceed to the Board of Tax Appeals and from there to the Supreme Court. Therefore, the Plaintiff is clearly pursuing administrative remedies concurrently.

However, the Court does not find such administrative remedies to be exclusive or exhausted and that Plaintiff is not required to conclude her administrative remedies to proceed with this action, particularly in a class action format.

O.R.C. 2723.01 implicitly gives the Common Pleas Court authority to find a taxing scheme illegal and the Supreme Court in *State ex rel. Tracy, supra,* has now so confirmed. The bottling industry in *Tracy* was not required to exhaust administrative remedies or pay the tax and seek refunds before seeking declaratory and injunctive relief.

In *Herrick v. Kosydar,* 44 Ohio St. 2d 128 (1975), the Supreme Court noted that administrative agencies are without jurisdiction to rule on the constitutionality of a statute and that forcing administrative exhaustion first would only result in futile delays. The matter eventually would end up in the Supreme Court either route. Further, the Supreme Court held:

> Whatever may be the rule in other jurisdictions, it is settled in Ohio that an action for a declaratory judgment may be alternative to other remedies in those cases in which the court, in the exercise of sound discretion, finds that the action is within the spirit of the Uniform Declaratory Judgments Act,

> Gen. Code, § 12102-1 *et seq.*, that a real controversy between adverse parties exists which is justiciable in character, and that speedy relief is necessary to the preservation of rights which may be otherwise impaired or lost. [Citations omitted. p. 130.]

As to the inability of administrative remedies to deal with class actions, the Court held (Per Curiam):

> Further, the present action is a class action, brought on behalf of an estimated 40,000 claimants. Administrative remedies would require each of those claimants to file a separate refund application, a requirement which can hardly be considered an equally serviceable alternative to a single declaratory judgment action. A class action provides various other procedural benefits and safeguards, as set out in Civ. R. 23, and offers clear advantages for large groups of litigants with similar interests. None of these advantages would be available in an administrative hearing, or in an appeal therefrom to the courts. [p. 130].

The Supreme Court found that a declaratory judgment action involving a large class seeking refunds of income taxes on state pensions to be "clearly a superior remedy for the Plaintiffs" (p. 130). Therefore, the Court finds that Plaintiff does not need to exhaust her administrative remedies and may proceed forward with this action.

III. DOES THE PLAINTIFF HAVE A RIGHT TO MAINTAIN A 42 U.S.C. § 1983 ACTION IN OHIO STATE COURTS?

The Court finds that Plaintiff does not have the right to maintain a 42 U.S.C. § 1983 action in Ohio State Courts.

Federal case law has clearly prohibited parties from attacking state tax matters in Federal Court under the

Tax Injunction Act of 1937, 28 U.S.C. § 1341, which provides:

> The district courts shall not enjoin suspend or restrain the assessment, levy or colleciton of any tax under state law where a plain, speedy and efficient remedy may be back in the courts of such state.

Fair Assessment in Real Estate v. McNary, (1981), 454 U.S. 100 broadened the application of the Tax Injunction Act finding that the financial stability of the States was best served by allowing state courts to deal with state remedies:

> Taxpayers must seek protection of their federal rights by *state remedies* provided, of course, that thoes remedies are plain, adequate, and complete, and may ultimately seek review of the state decisions in this court. [p. 116]

The *Fair* Decision also expands the prohibition to federal monetary damages as well as injunctive relief.

The majority of state courts have held that § 1983 actions cannot bc maintained in state courts either. This rationale is sound, and is not, as Plaintiff suggests, an attempt to shirk a state's responsibility to carefully examine the constitutionality of its own tax strutcure. But it defies rationale to expand state actions to include those challenges that are prohibited in federal courts, especially when state courts have adequate remedies to deal with the same issue.

One issue looked at by other jurisdictions ruling on § 1984 actions is the adequacy of speedy state remedies. In *Sunderland Properties, Inc. v. County of Berks,* (1990) 750 F. Supp. 704, the Pennsylvania Court noted that:

> A plaintiff's state remedy is plain, speedy and efficient if it provides the taxpayer with a full hearing and judicial determination at which the taxpayer

> may raise federal constitutional objections. *Rosewell v. LaSalle National Bank,* 450 U.S. 503, 514 [101 S. Ct. 1221, 1229, 67 L. Ed. d 464] (1981). . . . The state remedy that will suffice need only be adequate, and need not be coextensive with the remedies in federal court. In other words, the state remedy that will meet the requirement of plain, speedy and efficient need not be the best or most convenient one. [p. 707]

In this case, Plaintiff is pursuing both an administrative appeal and declaratory relief in State. Both remedies, especially the Tax Court, are speedy, efficient and afford full and adequate due process protection to the Plaintiff. The Pennsylvania Court put it well in *Greenwich Township v. Murtagh,* (1992) 144 Pa. Commw. 624, 601 A.2d 1352:

> We join the consensus of other state courts that a Section 1983 challenge to state tax administration is not maintainable if state remedies afford the taxpayer an opportunity for full and adequate relief. Both Congress, by enacting the Anti-Tax Injunction Act, and the Supreme Court, by its holding in *Fair Assessment,* prohibiting or declining to exercise jurisdiction, *have decided that federal interests are not advanced by allowing federal causes of action to intrude upon a carefully formulated state system designed to rectify state tax disputes.* Since federal courts decline to exercise jurisdiction because federal intrustion in state tax schemes is unwarranted, state courts should also not interfere, because its enforcement of Section 1983 is not less intrusive or disruptive than if enforced by a federal court. [Emphasis supplied, p. 1356]

The rationale is also well expressed in *North Dakota v. Quill Corporation,* upon rehearing, (May 11, 1993), Case No. 920283, 1993 N.D. Lexis 90, cert. denied on rehearing. The Court's conclusion summarizes this Court's Opinion succinctly (p. 15):

> A state might be forced to entertain in its own courts, suits from which it was immune in federal court.

Therefore, the Court finds that § 1983 actions for a tax challenge are not permissible in Ohio State Courts and that the Plaintiff possesses its full and fair remedies —a Tax Appeal and a Common Pleas Action—to challenge such tax structures.

IV. DOES O.R.C. § 5747.01(A)(A) WHICH TAXES INTEREST INCOME ON OBLIGATIONS OF NON-OHIO ISSUES WHILE EXEMPTING SUCH TAXATION OF OHIO OBLIGATIONS VIOLATIVE OF THE COMMERCE CLAUSE OF THE UNITED STATES CONSTITUTION?

The fourth issue and the heart of this case is whether the tax exempt status of Ohio issued bonds is illegal and/or unconstitutional, or in particular, violates the Commerce Clause of the United States Constitution.

The Court, having carefully reviewed all of the well-researched arguments of all three counsel, and having heard oral argument on the same, finds it does not.

This issues appears to be one of first impression in Ohio.

On July 13, 1992, Plaintiff Serene G. Shaper, filed the above-captioned action in the Cuyahoga County Court of Common Pleas seeking relief pursuant to R.C. § 2721.03 that R.C. 5747.01(A)(1) be declared unconstitutional as in conflict with Article I, § 8, Cl. 3 of the Constitution of the United States, the Commerce Clause, and that the Defendant, Tax Commissioner, be enjoined from assessing and collecting state income tax, pursuant to said statute, "upon interest earned by Ohio residents upon bonds issued by governmental entities outside the State of Ohio."

Under Ohio Rev. Code Ann. § 5747.01(A)(1) (Baldwin 1991), "adjusted gross income" for purposes of Ohio income taxation includes:

> interest or dividends on obligations or securities of any state or of any political subdivision of any state, other than this state and its subdivisions and authorities.

Plaintiff has purchased numerous out-of-state bonds, according to her tax returns. For example, in 1991, of $115,940.50 of reported Ohio taxable income, 26%, or $30,411.05 of income came from non-Ohio governmental obligations. Plaintiff has filed (and now been denied) a refund on the tax on those non-Ohio government obligation and concurrently filed this class action.

Shaper argues that R.C. § 5747.01(A)(1) discriminates against interstate commerce by making Ohio's governmental obligations more marketable in Ohio, by virtue of their state tax exemption, than the obligations of other states. She argues that the sole purpose behind the provision is to accomplish just this result—economic protectionism. Defendants argue that the Commerce Clause does not apply to interstate commerce between sovereign entities and that nevertheless, this activity is exempt as a market participant rather than a market regulation.

The Court finds that although the "market participant" theory applies, the better rationale is that the Commerce Clause was never intended to govern transactions between government entities.

Plaintiff has been able to cite no case law that is directly on point. All of the cases, in some form or fashion, deal with the state's involvement or protection of private enterprise that in some way favors a private entity within a state over another industry out of state.

Plaintiff repeatedly tries to rely on *Boston Stock Exchange v. State Tax Commission,* (1977), 429 U.S. 318,

50 L. Ed 2d 514. However, *Boston* fits into the same pattern of state protection of private enterprise. *Boston* involved an attempt by the State of New York, through its taxing powers, to provide a competitive edge to private business of the New York Stock Exchange, by imposing a higher tax on in-state transfers of securities resulting from out-of-state sales than those resulting from in-state sales, thus giving the New York Stock Exchange a competitive edge.

Noting that "The obvious effect of the tax is to extend a financial advantage to sales on the New York exchanges at the expense of the regional exchanges," 50 L. Ed. 2d 525, the Supreme Court found the statute to violate the Commerce Clause. The Court's key finding, which distinguishes *Boston* from government entities, is:

> Among these is the fundamental principle that we find dispositive of the case now before us. No State may, consitsent with the Commerce Clause, "impose a tax which discriminates against interstate commerce—*by providing a direct commercial advance to local business.*"
>
> The prohibition against discriminatory treatment of interstate commerce follows inexorably from the basic purpose of the Clause. Permitting the individual States to enact laws that *favor local enterprises* at the *expense of out-of-state businesses* "would invite a multiplication of preferential trade areas destructive" of the free trade which the Clause protects. [Emphasis supplied, citations omitted.] 50 L. Ed. 2d 525.

The key difference is the protection of *local enterprise.* In *New Energy Co. of Indiana v. Limbach,* (1988) 486 U.S. 269, dealing with Ohio's tax credit for ethanol produced in Ohio or for states granting reciprocal credits, again protection of private enterprise was involved and the Court invalidated the scheme. The Court found at p. 277 that:

> "the tax credit scheme has the purpose and effect of subsidizing a particular industry."

The Court went further in *New Energy Co.* in discussing the "market participant" theory which has evolved from several previous Supreme Court Decisions. Under the doctrine developed from these decisions, known as the "market participation doctrine," the Court has recognized that when the sovereign acts as a consumer or vendor in commerce, its actions as a market participant are distinct from its actions as market regulator (to which the Commerce Clause is directed), and are therefore exempt from Commerce Clause analysis, even though the actions provide discriminatory economic advantages to the state's private businesses. See *Hughes v. Alexandria Scrap Corp.* (1976), 425 U.S. 794, 49 L. Ed. 2d 200; *Reeves, Inc. v. Stake* (1980), 447 U.S. 429, 65 L. Ed. 2d 244; *White v. Massachusetts Counsel of Construction Employers, Inc.* (1983), 460 U.S. 204, 75 L. Ed. 2d 1; *South Central Timber Development, Inc. v. V. Wunnickl* (1984), 467 U.S. 82, 81 L. Ed. 2d 71.

These four cases developed the market participant theory, but *New Energy Co.* summed it up well (p. 277):

> That doctrine differentiates between a State's acting in its distinctive governmental capacity, and a State's acting in the more general capacity of a market participant; only the former is subject to the limitations of the negative Commerce Clause. *See Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 806-810, 96 S.Ct. 2488, 2496-2498, 49 L.Ed.2d 220 (1976). *Thus, for example, when a State chooses to manufacture and sell cement, its business methods, including those that favor its residents, are of no greater constitutional concern than those of a private business. See Reeves, Inc. v. Stake,* 447 U.S. 429, 428-439, 100 S.Ct. 2271, 2278, 65 L.Ed. 2d 244 (1980). [Emphasis supplied.]

Or as *Carll v. S.C. Jobs-Economic Devel. Authority* (1985), 372 S.E. 2d 331 (Supr. Ct., S.C.) states (p. 338):

> As a market participant, the State has the same rights as all other market participants. A trader may buy from whom he please, sell to whom he pleases and conversely, refuse to do so for reasons sufficient to himself.

In *New Energy Co.*, the state tried to justify the granting of tax credits to Ohio ethanol producers as a "market participant." But the Court found that not to be so; Ohio did not act as a seller or supplier or business itself in the ethanol process; Ohio merely provided tax control, which because it was *not* a state business activity (market participant) and because it *did* favor private business over out-of-state business, the tax credit was found to violate the Commerce Clause.

But again, *New Energy Co.* is distinguishable because it did *not* deal with commerce between state sovereigns, but rather protection of private enterprise.

An analogy can be drawn that in exempting its own governmental obligations from state income tax, that Ohio is acting as a market participant, as a business, and therefore free to seek a competitive edge. This Court can find no case that prohibits such action.

The better rationale is that neither the Supreme Court nor any case law examined has applied the Commerce Clause to actions between government entities. Each state has a legitimate interest in tapping a major source of tax revenue while adding an incentive for investors to purchase state bonds. Those purchasers then become the major beneficiaries of the issuance of the bonds for state issues, capital improvements, and similar benefits. To remove such an inducement would reduce a state's ability to fund its own debts, obligations, and capital improvements.

Carried to its extreme, Plaintiff's position would decry the federal government's ability to issue tax-exempt securities. Why should the federal government enjoy any greater protection from income tax in funding its obligations than state governmental obligations? Would not its own exemptions violate the Commerce Clause as much as the State's?

In conclusion, whether one treats a state in issuing its own tax-exempt securities and taxing those of other state entities as a market participant issue, or whether the Commerce Clause was simply never intended to apply to such state actions for its *own* protection, not that of private businesses, the Court finds that the Commerce Clause does not apply, and O.R.C. 5747.091(A)(1) is not unconstitutional.

Because of the holding reached by this Court, there is no need to address the issues of class certification.

Therefore, Plaintiff's Motion For Summary Judgment is DENIED and Defendants Roger Tracy, Tax Commissioner and Lee Fisher, Ohio Attorney General's Motion for Summary Judgment are GRANTED. Counsel for Defendants shall prepare a Judgment Entry within 10 days. Costs to Plaintiff.

/s/ E. Stratton
JUDGE EVELYN J. STRATTON

APPENDIX E

[Filed Dec. 7, 1993]

IN THE COURT OF COMMON PLEAS
FRANKLIN COUNTY, OHIO

Case No. 92CVH-11-9271

JUDGE EVELYN J. STRATTON

SERENE G. SHAPER,
Plaintiff,

v.

ROGER W. TRACY, TAX COMMISSIONER OF OHIO,
Defendant.

JUDGMENT ENTRY

This matter is before the Court on Cross-Motions for Summary Judgment filed by all parties. The Court, having reviewed the motions, briefs and oral arguments of the parties, agrees with the parties that there are no genuine issues of fact material to the case and that the case rests purely on issues of law. The Court, having carefully considered these issues, holds, for the reasons more fully set forth in its Decision of November 12, 1993, incorporated herein by reference, as follows:

1. The Plaintiff, pursuant to R.C. § 2723.01, has the right to maintain an action for declaratory relief to contest the constitutionality of R.C. § 5747.01(A)(1).

2. The Plaintiff has no obligation to first exhaust her administrative remedies pursuant to Personal Income Tax Refund Claim No. IT-6832 for tax years 1988-1991, currently pending before the Board of Tax Appeals, in which she has raised the same constitutional claim.

3. The Plaintiff has no right to an injunction under R.C. § 2723.01 unless, and not until, this Court would make a determination of illegality.

4. The Plaintiff has no right to maintain a 42 U.S.C. § 1983 action to contest the constitutionality of R.C. § 5747.01(A)(1) when she has full and adequate state remedies to deal with the same issue.

5. R.C. § 5747.01(A)(1), which taxes interest and dividend income on non-Ohio governmental obligations held by Ohio taxpayers while exempting the interest and dividend income of Ohio governmental obligations held by Ohio taxpayers, is not violative of the Commerce Clause, Article I, § 8, Cl. 3, of the United States Constitution.

WHEREFORE, Plaintiff's Motion for Summary Judgment is hereby DENIED;

The Cross-Motions for Summary Judgment of Defendants Roger W. Tracy, Tax Commissioner of Ohio, and Lee Fisher, Ohio Attorney General, are hereby GRANTED;

Costs are assessed to the Plaintiff.

JUDGE EVELYN J. STRATTON

APPROVED:

CLINTON A. KRISLOV
Attorney for Plaintiff

/s/ Andrew Bergman
ANDREW BERGMAN
Attorney for Defendant Lee Fisher

/s/ Lawrence D. Pratt
LAWRENCE D. PRATT
Attorney for Defendant Roger W. Tracy

APPENDIX F

Excerpt from Transcript of Proceedings

IN THE COURT OF COMMON PLEAS
OF FRANKLIN COUNTY, OHIO
CIVIL DIVISION

Case No. 92CVH11-9271

SERENE G. SHAPER,

Plaintiff,

vs.

ROGER W. TRACY, *ex rel.* Tax Commissioner of Ohio, and LEE FISHER, Attorney General of the State of Ohio,

Defendants.

TRANSCRIPT OF PROCEEDINGS

Before Judge, Evelyn Stratton, on Monday afternoon, September 13, 1993.

* * * *

[55] THE COURT: You are saying here because actually selling something, selling bonds and stocks and whatever else, bonds and securities that is the private industry they're engaging in?

MR. PRATT: Absolutely, just like they were selling cement in one of the other market participant cases that the Supreme Court addressed.

The doctrine applies both to the sale and purchase of goods. And as long as the state is on one side and acting

more like a private participant than as a state. They cite doctrine of loss. Once again, if the state is merely marketing its bonds more successfully by creating certain advantages to consumers of this to bonds, it's acting as a market participant.

That's what we would suggest the court find. If the court does not initially find—again, this is our first premise, that the clause doesn't apply to all. To this situation both on its case by its interpretation. If we get past those two stages. then we need to address the next issue, which is whether or not it's economic protectionism.

And the case law on that issue is specifically—and states that the whether a statute is a protection activity [56] measure, whether it is can be fairly viewed as a law treated to a legitimate local concerns is the test that the court must look at.

The case law also suggested that the burden is on the plaintiff to establish that there is protectionism involved. We don't think the plaintiff has met that burden in the instant case.

There hasn't been any facts presented to court on behalf of the plaintiff that would even remotely address themselves to that particular concern. All we have is a very generic, unconfirmed opinion of the plaintiff that it might be the case, no facts to establish it whatsoever.

THE COURT: But it seems pretty obvious somebody has to pay for tax, then we buy out of state.

MR. PRATT: But the intent must be to create that result. And that hasn't been proven.

THE COURT: What other intent could be intended?

MR. PRATT: We have attached to our memorandum in opposition and in support of our own motion for summary judgment an affidavit. That affidavit contains factual information from one of the individuals who was responsible in drafting and creation of the particular statute at issue, an individual testified extensively before the general assembly as to the pros and cons of the [59] Boston Stock Exchange case look at a couple of key factors of factual nature in each of those two decisions

in reaching their ultimate conclusion that a violation in both cases. It was virtually stipulated on the record by both parties that the only purpose behind the measure was to—for economic protectionism.

It was expressly found to be a factual determination by the court in each of those two decisions. And there was also another circumstance that was looked at as an implied proof that there wasn't any other purpose behind the measure.

In each case it was noted by the court that there wasn't any significant revenue derived from the state as a result of the measure in issue.

As the court has already indicated, that's not the case here. We're talking about $20 million a year in annual revenue to the state of Ohio. Although Mr. Krislov may not know—the court is well aware, we're going through very tough economic times in Ohio.

And I would submit to the court that the State of Ohio would not likely throw away $20 million when it's trying to balance its budget.

There is a significant purpose behind this measure. It would create substantial financial harm to the State of Ohio if it was struck down. That, to me, goes straight [60] towards the argument that there was no other reason behind this measure than to somehow create an economic protectionism facet for the state's bonds.

I would submit to the court further that to the extent that if there is a disparity involved here, it's a disparity that's entirely consistent with the sound policy of this state. If, in fact, it stirs the market behind Ohio bonds in the State of Ohio, where better should that market be? It is the citizens of Ohio that are being benefitted by those Ohio bonds. Why shouldn't they be encouraged to purchase the bonds in their own state?

That is economic protectionism. That is the life blood of the sovereign itself. That is a government function. And I think that function falls well within the policy behind the measure. And I do not think that policy is inconsistent with the United States Commerce Clause.

I don't think in any way it favors the private business over other private business. I think it goes to the sound and fundamental operation of the sovereigns themselves. I think that would be construed to be entirely consistent with the United States Constitution.

Based upon all of those factors, we don't think that the plaintiff has met its burden of establishing commerce clause violations.

* * * *

APPENDIX G

The Wall Street Journal
December 14, 1993 at C19

OHIO SUIT THREATENS TAX ADVANTAGES OF BUYING SINGLE-STATE MUNI FUNDS AND IN-STATE BONDS

By THOMAS T. VOGEL JR.
Staff Reporter of The Wall Street Journal

NEW YORK—Investors scrambling to buy municipal bonds or to invest in municipal-bond funds ahead of next year's big tax increase should take notice of a class-action lawsuit filed by a bondholder against the state of Ohio.

With the benchmark 30-year Treasury bond yielding 6.23% yesterday, up from 6.20% on Friday, many investors are looking to muni bonds for a boost. That's because they expect muni-bond yields, relative to Treasurys, to drop even further as the tax increase and a wave of bond calls in January spur demand.

But for investors in certain types of bonds and bond funds, the Ohio lawsuit may become a bitter pill. The suit, filed by Serene G. Shaper of University Heights, charges that the state is violating the U.S. Constitution by imposing its income tax on income from out-of-state municipal bonds. Most states tax the income of the tax-exempt bonds of other states.

Municipal-bond market experts are worried about the case even though a judge in the Franklin County Court of Common Pleas has already ruled against Ms. Shaper. Her attorney, Clint Krislov, says he plans to appeal the case and try to take it to the U.S. Supreme Court.

If he's successful, it would be bad news for the thriving $132 billion market for single-state municipal-bond funds.

These funds, which specialize in buying the bonds of a single state, are designed to take advantage of the extra tax advantages for residents of those states if they buy in-state bonds. According to Lipper Analytical Services, there are 778 of these funds nationwide.

Oftentimes a bond from your own state will be exempt from federal, state and local taxes. But if Ms. Shaper prevails in her lawsuit in higher courts, such bond funds could lose this advantage. That's because a precedent would be set that could possibly force other states to lift taxes on out-of-state municipal bonds.

"This is something that will never be favorably ruled on at the state level," said Richard Lehmann, president of the Bond Investors Association. "It does have to go to the Supreme Court . . . and there are many reasons to think that the Supreme Court looks unfavorably on these situations." If the lawsuit were finally successful, said Mr. Lehmann, "there would be no point to single-state bond funds."

A ruling in favor of the suit could have a devastating effect on the value of single-state bond funds, said Mr. Lehmann. But appealing the ruling in Franklin County and taking the case to the U.S. Supreme Court "could take a while," Mr. Krislov said.

Such taxing practices, argued Mr. Lehmann, "give some states a certain advantage in the municipal-bond market at the expense of other states." States with low taxes and a small population, for example, see the demand for their bonds weakened when larger states with higher taxes levy taxes on the income from the smaller states' bond issues. A legal precedent that prevented states from taxing the income from municipal bonds of other states could help boost demand for such low tax states, said Mr. Lehmann. "It may be good for the municipal market," he added, "because it could improve the market's liquidity."

The suit, which was filed last year in the Cuyahoga County Court of Common Pleas, argues that Ohio's practice of taxing out-of-state municipal bonds is an "unambiguous discrimination against interstate commerce, solely a protectionist measure that cannot withstand scrutiny under the Commerce Clause" of the U.S. Constitution. The suit names Roger W. Tracy, director of the Ohio Department of Revenue, as the defendant.

In her decision last month, Judge Evelyn J. Stratton of the Court of Common Pleas in Franklin County ruled that "the Commerce Clause does not apply" to this particular case. Her decision said that "neither the Supreme Court nor any case law examined has applied the Commerce Clause to actions between government entities."

Mr. Krislov said he expected such a decision. "We always knew from the beginning that this case would have to get to the Supreme Court," he said, "because no state is going to voluntarily surrender its ability to tax out-of-state bonds."

Meanwhile yesterday, Treasury securities posted moderate losses during light trading in response to a jump in precious-metals prices. For much of the session, the February gold futures contract was up more than $4 an ounce, flirting with $390. A rise in gold prices is often taken as a sign of growing inflation, which reduces the value of investments with a fixed rate of return. But a drop in the prices of other commodities, such as oil, helped ease inflation concerns.

Meanwhile, yesterday the U.S. Treasury also sold $26.15 billion of three-month and six-month bills at its regular weekly auction. The three-month bill was sold at an average discount rate of 3.06% for a coupon-equivalent yield of 3.12%. The six-month bill was sold at an average discount rate of 3.26% for a coupon-equivalent yield of 3.36%

* * * *

APPENDIX H

The Bond Buyer
September 9, 1993 at page 1, column 3

OHIO'S TAX ON OUT-OF-STATE BONDS SPURS SUIT THAT WORRIES INDUSTRY

By Karen Pierog

CHICAGO—A lawsuit charging that Ohio is violating the U.S. Constitution by taxing income on out-of-state municipal bonds could seriously affect the municipal market, industry observers said yesterday.

The class action suit, which was filed last year by a bondholder in a Cleveland suburb, claims that Ohio, which exempts its own bonds from its income tax, is violating the commerce clause of the Constitution with its tax.

Specifically, the suit charges that "the imposition of state income tax upon interest paid by non-Ohio governmental entities is an unreasonable burden on interstate commerce and is nothing more than a protectionist measure that cannot withstand scrutiny under the commerce clause of the United States Constitution."

Last month Franklin County Common Pleas Court Judge Evelyn J. Stratton ruled in Ohio's favor, saying the commerce clause "was never intended to govern transactions between government entities."

However, Clint Krislov, a Chicago attorney representing Serene G. Shaper, the bondholder, said the decision will be appealed to the Ohio Court of Appeals and that he expects to take the case all the way to the U.S. Supreme Court.

"There is no question in my mind that the court will hold that state bonds are instruments of commerce," Krislov said.

He contended that states are participating in a market when they issue bonds and that states that tax income on other states' bonds are using their taxing power to "discriminate in interstate commerce."

Currently, 42 states collect income taxes on out-of-state bonds, while exempting all or some of their own bonds from taxation.

Municipal industry observers said the success of such a lawsuit in the U.S. Supreme Court would have implications for mutual funds that offer single-state funds and for the market as a whole, which would both lose the advantages of double tax-exemption on bonds. In addition, states that levy an income tax on out-of-state bonds could lose millions of dollars of annual revenues.

Richard Lehmann, president of the Bond Investors Association, said that if the suit prevails, "there would be a major, major change in the municipal market."

"All the state funds that were created as tax shelters would all be pointless." Lehmann said, "It would also mean that every municipal bond would be marketable in every state because of equal tax treatment, and that would tremendously liquefy the municipal market because everyone would be in the market for every bond."

On the other hand, Lehmann said some issuers, such as New York City, would see their cost of issuance "skyrocket" because the benefit of double tax exemption would be gone for buyers in the city, and those buyers could put their money in "safer paper."

Richard Ciccarone, a senior vice president and director of tax-exempt fixed-income research at Kemper Securities Inc., agreed that a favorable decision in the case "would throw the specialty state market in disarray."

"The disruption in the market would be substantial, victimizing buyers of in-state paper who were willing to accept lower interest rates because of the double tax ex-

emption and now have concentrated risk," Ciccarone said.

Andrew Jennings, manager of the municipal trading desk at Franklin Advisors Inc., said the impact on single-state funds would depend on whether the high court would rule retroactively or prospectively.

Heather Ruth, president of the Public Securities Association, said while the group has no position on the matter, its policy has been to let states decide how to tax interest on their bonds or the bonds of other states.

"If for any reason the tax liability would be removed on outstanding bonds, it would raise the value of the bonds commensurately," Ruth said.

Krislov said the Ohio case is supported by recent Supreme Court decisions that struck down the higher taxes states were charging on materials such as toxic waste from other states.

"You can't tax incoming toxic waste more heavily than in-state toxic waste," Krislov said. "And you can't treat the bonds of a sister state as if they were an incoming Scud [missile] either."

Krislov said he might file similar cases in other states, but declined to name the states.

The momentum in the Supreme Court "seems to be in the direction of a kind of seamless economy," Lehmann said, which could help the Ohio case.

The case also has a supporter in James F. Blumstein, a law professor at the Vanderbilt Law School, who addresed the matter of state taxation of municipal bonds in an article written in 1978.

"The argument that this is purely a government thing is ridiculous," Blumstein said. "This is an industry—not just a government—issuing bonds."

Moreover, the system of double tax exemption in some states actually leads to higher bond yields for some issuers whose bonds are marketed out of state and must have yields that will attract investors who will have to pay their states' income tax on the bonds, Blumstein said.

Lawrence Pratt, Ohio's assistant attorney general who represented the state, said he feels confident that the state will prevail. Judge Stratton "completely" accepted the state's argument that the commerce clause cannot be applied to a state marketing its own products, Pratt said.

Pratt said Ohio began taxing the income on out-of-state bonds in the 1970s and that the state collects about $20 million annually from taxing those bonds.

APPENDIX I

The Bond Buyer
March 22, 1995 at Page 1, Column 2

PROPOSED MINNESOTA BILL WOULD TAX INTEREST FROM STATE, LOCAL BONDS

By Cris Carmody

A Minnesota lawmaker has sparked jitters in the municipal market by introducing a bill to eliminate the tax exemption now extended to its state and local bonds.

The bill, introduced last week by Rep. Ann Rest, D-New Hope, would impose the state's income tax on the interest earned from all state and local bonds sold after July 1, 1995. Minnesota's income tax, which has a maximum rate of 8.5% would also apply to bonds sold in the secondary market after July 1, regardless of when the debt was initially issued.

If the bill were enacted, Minnesota would join five other states that tax interest income on most of their own bonds—Illinois, Iowa, Kansas, Oklahoma, and Wisconsin.

Some observers estimate that Minnesota could raise $3 million to $4 million annually if the measure becomes law.

Executives in the municipal bond industry were not plead by the proposal.

"I don't think there's much to say other than I'm not happy about it," said Michael Brilley, senior vice president of Sit Investment Associates', which manages the Sit Minnesota Tax-Free Income Fund consisting solely of Minnesota state and local bonds. "It seems dumb to me," he said.

But a House legislative analyst defended the bill. Joel Michael said Rest and her co-sponsors proposed the tax change to head off liability now in the Ohio courts.

The plaintiff in that suit, Serene Shaper, alleges that Ohio violates the commerce clause of the U.S. Constitution when the state taxes income only on out-of-state bonds.

Shaper, however, lost at the trial court level and the Ohio Appeals Court ruled against her last September. The Ohio Supreme Court has declined to hear the case, and Shaper's lawyer, Clint Krislov, said he will ask the U.S. Supreme Court this spring to hear the case.

Minnesota lawmakers have grown cautious about the impact of litigation since January, when the U.S. Supreme Court ruled against the state in a case brought by bankers challenging a law that taxed some federal transactions but not state transactions. As a result, the state must pay $327 million to Cambridge State Bank and other plaintiff banks. "The way the Supreme Court has imposed remedies on the states, we envision two unpalatable alternatives [if Shaper succeeds]. We would either have to exempt the bond interest on out-of-state issues for all open tax years for everyone who files for an income tax refund, or we'd have to retroactively tax Minnesotans on existing bonds," said Michael.

He added lawmakers had two other concerns. Because most bondholders are higher-income citizens, lawmakers find the tax exemptions inequitable. And he said the sponsors worry that because the bonds carry an attractive interest rate to lure out-of-state buyers, Minnesotans who buy un-taxed in-state bonds have an unfair advantage. And the higher interest rate, Michael said is detrimental to issuers.

Municipal officials disagree. "We're opposed to the bill because we're concerned about the impact on borrowing costs for cities," said Gary Carlson, director of intergovernmental affairs for the Minnesota League of Cities. "It certainly would probably hurt smaller cities."

He noted that some bond lawyers told him they rewrote offering documents for pending issues over the weekend to make sure disclosure on the proposal was included.

Ironically, one of the first issues to be priced since the bill's introduction was a $115 million competitive offering from the state of Minnesota. The specter of taxability concerned some market observers, said the state's assistant commissioner of finance Peter Sansen.

Bear, Stearns & Co. won the issue yesterday and an official said the bill had no effect on the pricing. However, Sansen said some investors were worried because if the bill passed, the bonds would become taxable on the secondary market.

"I talked to some buyers of the bonds who were concerned about it. One major investor said he was not going to buy the bonds because of it," Sansen said.

Minnesota House officials said they're aware the measure is not popular among public financiers. "The local investment banking community is strongly opposed to it, because the existing double tax exemption makes it easy for them to sell municipal bonds locally," said Michael.

The Minnesota House Committee on Governmental Operations will hold a hearing on the bill tomorrow.

Prospects for enactment are unclear; the Democratic Farm Labor Party controls both the Minnesota House and Senate, but Gov. Anne Carlson is an Independent-Republican. Carlson's administration has not taken a position on the bill.